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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 899

EDMUND THOMAS GULLEDGE, SR., and LUCY COULTER GULLEDGE, Husband and Wife, *Petitioners*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

To the Honorable, Chief Justice, and the Associate Justices of the Supreme Court of the United States.

The petitioners, appellants below, pray that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fourth Circuit entered in the above cause on November 7, 1957. (Appendix 19a)

OPINIONS BELOW

The Tax Court of the United States did not render a written opinion in this cause. Its memorandum findings of fact and opinion was filed on February 13, 1957. (App. 1a)

The opinion of the United States Court of Appeals for the Fourth Circuit is set forth at page 15a of the Appendix.

JURISDICTION

The jurisdiction of the Court is invoked under Sec. 1254 (1), Title 28 of the United States Code.

The Judgment of the United States Court of Appeals for the Fourth Circuit here sought to be reviewed, was entered on November 7, 1957. An order extending the time to April 5, 1958 within which to file this petition for a Writ of Certiorari was entered on January 31, 1958.

QUESTIONS PRESENTED

I. Do payments made for the benefit of a corporation by an individual stockholder pursuant to his independent agreement with a third party result in losses under the provisions of Sec. 23(e), or in bad debts under Sec. 23(k) of the Internal Revenue Code of 1939 as amended?

II. If such payments are to be treated as bad debts, are they deductible as business bad debts under Sec. 23(k)(1) or as non-business bad debts under Sec. 23(K)(4) where the stockholder, a peanut grower, made the payments for the benefit of the corporation which processed the peanuts he grew?

III. Are loans made by a peanut grower-stockholder, directly to the Corporation which processed the peanuts grown by him, deductible as business or as non-business bad debts when not repaid?

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations, set forth in the appendix, are

26 U.S.C. Sec. 23(e)
26 U.S.C. Sec. 23(k)
Treasury Regulations 111, Sec. 29.23(k)-6
Treasury Regulations 118, Sec. 39.23(k)-6

STATEMENT OF FACTS

Petitioners are husband and wife, residents of Sumter County, South Carolina. Edmund Thomas Gulledge, Sr., hereinafter referred to as petitioner, is a farmer who during all years material hereto farmed 1500 to 2000 acres of which approximately 400 acres were in peanuts. The total peanut acreage of Sumter County was about 4000 acres.

Prior to 1946, petitioner and the other peanut growers had no local or state market for their peanut crops. The nearest markets were 150 to 200 miles away in North Carolina. As a result the growers in Sumter County were at an economic disadvantage and not able to get fair prices for their crops because they were obliged to sell individually to itinerant buyers for whatever price they could negotiate.

In 1946, the Sumter County Farm Agent, aware of the dissatisfaction among the peanut growers of the county and their specific complaints as to lack of uniform grading, excessive haulage charges, packaging costs, prices obtainable, and delays in receiving payments, approached petitioner and two other large producers in the county and urged them to jointly establish a local market and processing plant. Together these individuals visited the markets and peanut companies in Georgia and Virginia to determine whether such a venture would be feasible. Upon receiving encouraging reports they formed the Sumter Peanut and Produce Corporation in July 1946.

On December 31, 1947, the capital of the Corporation and its stockholders were as follows:

Petitoner	155 Shares	$15,500
W. J. Lawrence	155 Shares	15,500
H. C. Edens	110 Shares	11,000
T. O. Bowen	60 Shares	6,000
	480 Shares	$48,000

The petitioner and the other farmer-stockholders each considered this operation as being directly related to, connected with, and a part of their farming activity. An immediate result was an increase in peanut prices to all the growers in the County of from $25 to $30 per ton.

At various times when the Corporation did not have the necessary funds with which to purchase peanut crops, petitioner and the other stockholders loaned funds. The total of the amounts so loaned by petitioner directly to the Corporation through February 1951 was $14,817.04.

It had been the practice of the Corporation to issue warehouse receipts for the peanuts as they came into the plant. These warehouse receipts were then required to be paid off before the peanuts were shelled. Late in 1951 however, it was discovered that the plant manager had been shelling peanuts before making payment. This, coupled with a decline in the market price of shelled peanuts of from $100 to $130 a ton, made it questionable that the Corporation would be able to pay off the outstanding warehouse receipts.

Petitioner and the other stockholders advised the South Carolina State Warehouse System, Agriculture Department, of the situation, and in their individual capacities, entered into the following agreement on November 29, 1951.

> "WHEREAS, the undersigned Stockholders and Directors of Sumter Peanut & Produce Corporation, do hereby assume reponsibility and personal liability for the retirement of all outstanding warehouse receipts in State Warehouses Nos. 1179-G, 1096-G, 1233-G; and
>
> WHEREAS, the undersigned parties do admit that they are responsible for said warehouse receipts no matter how many, and what amounts, together with all storage charges thereon, and agree to fully retire and counsel [sic] the same on or before the 15th day of December 1951.
>
> Now, THEREFORE, in consideration of the premises, we, the undersigned, do hereby bind ourselves to

retire and cancel all of said warehouse receipts, together with storage on or before December 15, 1951.

This Agreement shall be binding upon the parties hereto, their heirs and assigns.

Witness the hand and seal of the parties hereto this the 29th day of November, 1951.

/s/ E. T. Gulledge
W. J. Lawrence
R. E. Colvin

STATE OF SOUTH CAROLINA
COUNTY OF SUMTER

Personally appeared before me W. E. Pate, who, being duly sworn says that he was present and saw the within E. T. Gulledge, W. J. Lawrence, and R. E. Colvin sign, seal, and as their act and deed deliver the foregoing written Agreement and that he with M. M. Weinberg witnessed the due execution thereof.

Sworn to before me this the
29th day of November, 1951

/s/ W. E. Pate

/s/ M. M. Weinberg
Notary Public for S.C."

In discharge of the liabilities arising from the Agreement, petitioner subsequently paid $31,500. The other stockholders paid various lesser amounts.

The Tax Court of the United States had jurisdiction under 26 USC Sec.6213. The Court of Appeals affirmed the Tax Court's determination that upon failure of the corporation, petitioner realized only a non-business bad debt. Neither the Tax Court, nor the Court of Appeals made any distinction as between monies loaned directly to the Corporation and monies paid pursuant to the indemnity agreement set forth above.

ARGUMENT

Your petitioner respectfully urges this Honorable Court to grant the petition for a Writ of Certiorari prayed for in this cause for the following reasons:

(a) The questions here presented have not been settled by this Court, and are of national importance not only because of their impact upon the Federal Revenue and the large number of taxpayers involved but further because of the large volume of litigation resulting therefrom.

This Court in *Putnam* v. *Commissioner of Internal Revenue* (1966) 352 US 82, affirmed its previously stated views[1] that the loss provisions and bad-debt provisions of the Code[2] were mutually exclusive. It was further held that a guarantor's loss was deductible only under the bad-debt provisions, since by subrogation, a debtor-creditor relationship thereafter existed.

Historically, the deduction provisions of Sec. 23(e) and 23(k) have proved troublesome to taxpayers, the Government and Courts. Confusion has resulted because of their apparent overlap in many situations. Although the *Putnam* case does much to clear up some of the long existing confusion, there now remains to be established realistic guides or standards with which to extend the Putnam rationale into that still unsettled, but directly related area involving independent indemnity or quasi guaranty, surety and endorsement agreements where, absent subrogation, no debtor-creditor relationship results. Likewise, aids are needed to apply realistically the terms '*incurred in trade or business*', and '*incurred in any transaction entered into for profit . . .*', particularly in light of the fact that in either instance a loss is deductible in full, whereas a bad-debt is not, being limited by 23(k)(4) to only those occurring in a trade or business.

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[1] *Spring City Co.* v. *Commissioner*, 292 U. S. 182.

[2] Internal Revenue Code of 1939 as amended.

(b) The Opinion of the United States Court of Appeals for the Fourth Circuit in the instant case misinterprets the reasoning and logic of the *Putnam* case.

The holding of this Court in the *Putnam* case is that the loss and bad-debt provisions of the Code are mutually exclusive and the sine qua non to the application of the bad-debt section is the debtor-creditor relationship which may be direct and original, or may be indirect or collateral as where it results by virtue of subrogation.

In the instant proceeding, the Court of Appeals did not give consideration to the independent indemnity agreement entered into by petitioner which resulted in the major portion of his liability. This agreement establishes the legal status of the parties, and, being an indemnity, does not give rise to subrogation and no subsequent debtor-creditor relationship. The Court of Appeals ignores the legal distinction between funds paid pursuant to the indemnity agreement and those loaned directly to the Corporation, lumps them all together under the generic term 'loss' and concludes them to be non-business bad-debts.

Petitioner submits that the erroneous conclusion of the Court of Appeals results from their having assumed a false basic premise, directly caused by ignoring the *Putnam* rationale, to the effect that the debtor-creditor relationship is essential to the application of Sec. 23(k).

The Court of Appeals has therefore decided a Federal question in conflict with the applicable and controlling decision of this Court.

(c) Additionally, petitioner submits that the Court of Appeals erred in concluding that those funds advanced directly to the Corporation are non-business bad debts.

After finding that a business need existed for the Corporation, the Court then states:

> " . . . as a result the growers in the county obtained an advance from $25 to $30 per ton on the price of

their peanuts; and the investors testified that they considered the business of the Corporation as part of their farming operations. . . .

" . . . It is true that the taxpayer and the other stockholders were induced to contribute to the capital of the corporation in the hope that the establishment of a peanut mill in their neighborhood would enable them to secure a better price for their peanuts, and hence it may be said in a broad sense that the business of the farmers and the business of the Corporation were related." (App. 18a).

After so concluding, thereafter to find the advances to be non-business is a *non-sequitur* that represents not only a departure from accepted legal reasoning, but by its affirmance of the trial court, the Court of Appeals has also sanctioned that same error and illogical conclusion of the Court below.

I

Payments Made for the Benefit of a Corporation by an Individual Stockholder Pursuant to His Independent Agreement With a Third Party Result in Losses Under the Provisions of Sec. 23(e) rather than bad-debts under 23(k) of the Internal Revenue Code of 1939 as Amended.

The doctrine of the *Putnam case* requires the existence of the debtor-creditor relationship as a condition precedent to the recognition of a deduction under Sec. 23(k). This relationship may either be direct or the result of subrogation as a guarantor, endorser, or surety.

Absent the essential debtor-creditor relationship however, Sec. 23(k) is not applicable and any deduction is cognizable only under Sec. 23(e) as a loss.

For the purpose of these mutually exclusive provisions an indemnitor stands in a different legal position than does a guarantor or other person secondarily liable. The controlling principle is stated in *Howell* v. *Commissioner of*

Internal Revenue (CCA-8; 1934) 69 F. 2d 447; cert. denied 1934, 292 U.S. 654, as follows:

> "Although the ordinary surety or guarantor is a creditor of the principal debtor, the same cannot be true of an indemnitor who does not undertake to assume or discharge the obligations of another, but has, on his own account, contracted to pay a sum of money upon the occurrence of a certain event usually the happening or the ascertainment of a loss. There is no privity, either actual or implied, between the promisor in the undertaking the loss from the non-performance of which is indemnified against, and the indemnitor, and the latter, if the loss occurs, does not, by payment of it, discharge anyone's obligations but his own."

The petitioner-stockholder here paid the sum of $31,500 which although of indirect benefit to the Corporation was nevertheless his individual obligation paid pursuant to the independent agreement to which the Corporation was not privity. The obligation discharged was the primary liability of the individual petitioner and not a secondary or collateral liability. Since he paid no obligation other than his own, he had no legal right thereafter to look to the Corporation for reimbursement. There was no privity, no subrogation, nor any resulting debtor-creditor relationship.

The Court of Appeals failed to distinguish between those payments made pursuant to the agreement, and the loans made directly to the Corporation. That Court ignored the fact that petitioner had no right to look to anyone for repayment and erred by concluding that the loss thus suffered was deductible as a bad debt under section 23(k) despite the absence of the debtor-creditor relationship.

Absent the necessary condition precedent required by the *Putnam case* for the creation of a bad debt, and since the loss and bad debt provisions are mutually exclusive, logic requires that these payments if otherwise deductible be recognized only as losses under Sec. 23(e).

II

If Such Payments Are to Be Treated as Bad Debts They Are Then Deductible as Business Bad Debts Under Sec. 23(k)(1) Where the Stockholder, a Peanut Grower, Made the Payments for the Benefit of the Corporation Which Processed the Peanuts He Grew.

Petitioner urges in part I supra, that the $31,500 paid by him as an indemnitor should properly be allowed as a loss under Sec. 23(e). In the alternative, however, should this Court hold, as did the Court of Appeals, that such payments are deductible only as bad debts, petitioner then urges that they must be treated as *business* bad debts under Sec. 23(k)(1).

If all distinction between the indemnity payments of $31,500 and the direct loans to the Corporation in the amount of $14,817.04 is to be disregarded, the indemnity payments then assume the same legal character as the direct loans, and the argument that follows is equally applicable to both.

III

Loans Made by a Peanut Grower-Stockholder, Directly to the Corporation Which Processed the Peanuts Grown by Him Are Deductible as Business Bad Debts When Not Repaid.

Section 23(k)(1) allows, with exceptions not here pertinent, a deduction for the full amount of bad debts other than those defined as non-business bad debts by Sec. 23(k)(4).

The provisions of Sec. 23(k)(4) were added to the Code by the Revenue Act of 1942. The legislative intent and purpose sought to be accomplished by the enactment of this provision seems to be clearly established by the House Ways and Means Committee Report:[1]

> "C. Nonbusiness Bad Debts.
>
> "The present law gives the same tax treatment to bad debts incurred in nonbusiness transactions as it

[1] H.R. Rep. No. 2333, 77th Congress, 2d Session, p. 77.

allows to business bad debts. An example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer's trade or business. This liberal allowance for nonbusiness bad debts has suffered considerable abuse through taxpayers making loans which they do not expect to be repaid. This practice is particularly prevalent in the case of loans to persons with respect to whom the taxpayer is not entitled to a credit for dependents. This situation has presented serious administrative difficulties because of the requirement of proof."

The pertinent regulations are likewise helpful.[2]

"Nonbusiness Bad Debts

"The character of the debt for this purpose . . . is to be determined . . . by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, *the debt is not a nonbusiness debt for* the purposes of this section." (Italics supplied).

The legislative purpose for the enactment of Sec. 23(k)(4) as disclosed by the House Report *supra*, coupled with the official interpretation given to it by the Treasury Department which is responsible for its application, clearly indicates that the term "non-business bad debts" means only those which were neither incurred in a trade or business nor proximately related thereto. The application of Sec. 23(k)(4) was clearly intended to cover those bad debts that resulted from personal transactions having no legitimate business purpose.

Against this background it is difficult to see how the Court of Appeals can hold that the transactions here resulted in non-business bad debts

[2] Sec. 29.23(k)-6 of Regulations 111 and Sec. 39.23(k)-6 of Regulations 118.

The petitioner was a commercial grower of peanuts, one of the largest in the county. The welfare of these farmers; experience had shown, depended upon the facilities and services provided by the peanut processing Corporation. As a businessman, petitioner made the loans in an effort to protect the market for his product. This purpose is no less proximate to a business than protecting a source of supply. The debts here in question were not the result of loans to friends or relatives or debts that bore no relation whatsoever to the business in which petitioner was engaged, but, on the contrary were interrelated with, and inseparable from his business as a peanut farmer. It is fundamental that the business of being a farmer connotes as a necessary incident or adjunct thereto the processing and selling of the crop in the most advantageous manner. It is folly to hold that the business aspects of the farming operations cease at the moment the crop is harvested, and that activities thereafter are neither proximate to, nor a part of the business of farming.

The profit petitioner realized from his labors, and his resulting taxable net income were directly dependent upon the price for which he could sell his product. It is not disputed that local marketing problems had placed petitioner and others similarly situated at an economic disadvantage. As their product was perishable, the buyers could dictate the terms, nor was their economic bargaining position bettered by the costly transporting of their crops to established markets 150 to 200 miles away. The higher price they might there receive was more than offset by the additional expenses involved.

In an effort to improve the economic plight of these growers, the County Farm Agent induced the major growers to use their initiative to form a processing plant and thereby establish a local market. This was done and the immediate and direct result was an increase of

$25 to $30 a ton received by all local growers for their peanut crops.

At a later date, when the Corporation which purchased, warehoused and processed their crops, encountered financial difficulties, the petitioner and the other stockholders made direct loans to the Corporation. It is unrealistic to say that such loans were neither proximate to, nor directly related to their activities as peanut growers.

In holding that the taxpayer's losses in *Putnam supra* were non-business bad debts this Court stated:

> " . . . His venture into the publishing field was an investment apart from his law practice. . . . "

Here however, such was not the case. This was no venture into an unrelated field but rather an abiding effort on the part of this taxpayer to make a success of his peanut farming business. The economic facts of life forced this farmer to make these various expenditures, which included his investment in the capital stock of the Corporation (the loss of which is not here involved), his loans directly to the Corporation and his later losses as an indemnitor.

There are numerous decisions in which taxpayers similarly situated have been afforded "business bad debt" treatment. In *Estate of Robert Haverty*, T. C. Memo Op., Nov. 12, 1953 (Doc. Nos. 33832, 34463), the estate of the deceased taxpayer was allowed a business bad debt deduction for liability incurred pursuant to an instrument whereby he guaranteed the credit of the corporation which manufactured the furniture which his partnership was selling; in *Tony Martin* (1955), 25 T.C. 94, (acquiescence by Commissioner, 1956-1 CB4), the taxpayer's advances to a corporation formed to rejuvinate and rehabilitate his career were allowed as a business bad debt; in *J. T. Dorminey* (1956), 26 T.C. 940 a wholesale produce dealer was allowed business bad debt treatment for funds which he advanced to a

corporation organized to import bananas. The Tax Court held

> "The petitioner was a large shareholder and vice president of the debtor corporation. He was engaged in the produce business and had a market for about two carloads of bananas a week, but he could not obtain bananas because of economic conditions. Navigation [the corporation] was formed to bring bananas here from Central America and Cuba. Petitioner invested in Navigation for the purpose of obtaining bananas. The advances were incidental to and proximately related to his produce business. The resulting bad debt loss was incurred in trade or business and is deductible under Section 23(k)(1)."

See also, *Estate of Lawrence Weil* (1957), 29 T.C. No. 40; *Arthur Rubel et al.*, T.C. Memo. 1954-135; *Stuart Bart* (1954) 21 T.C. 890; *Robert Chutt, 3rd* (1947), 8 T.C. 1178.

CONCLUSION

The Fourth Circuit, by lumping loans made to the corporation with payments made pursuant to an indemnity agreement, and attaching the same legal character to each, has extended the doctrine of the *Putnam* case into a new and unintended field. We respectfully submit that this error alone is sufficient to grant the writ.

In addition, the failure to administer to these taxpayers the tax treatment to which they are entitled and which has been accorded other taxpayers in like circumstances, is clearly not "equal justice under the law." At the present time, there is a crying need for the establishment of realistic standards to distinguish between business and non-business bad debts. These can be provided only by this

Court, for which reason it is respectfully submitted that this writ be granted.

Respectfully submitted,

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APPENDIX

T. C. Memo. 1957-29

TAX COURT OF THE UNITED STATES
EDMUND THOMAS GULLEDGE, SR., AND LUCY COULTER GULLEDGE, Husband and Wife, Petitioners, *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent,

Docket No. 59548. Filed February 13, 1957.

1. During the taxable years 1951 and 1952 and for many years prior thereto, petitiner Edmund Thomas Gulledge, Sr., was engaged in the business of farming. He devoted a part of his land to the raising of peanuts. In 1946, he and three other individuals organized a corporation to engage in the business of shelling and marketing peanuts. During the years 1949 to 1952, inclusive, he advanced a total of $46,367.04 to the corporation. *Held,* the advances were loans to the corporation rather than capital contributions. *Held, further,* a part of the loans became entirely worthless in 1951 and the remainder was entirely worthless in 1952 when made pursuant to the agreement of November 29, 1951. *Held, further,* the worthless debts were deductible as nonbusiness rather than business bad debts. *Held, further,* the worthless debts are not deductible under either section 23 (a) (1) or (e) (2), I.R.C. 1939.

2. During 1953, petitioner constructed a pond on his property primarily for his cattle and for irrigation purposes. *Held,* the cost of constructing the pond is a capital expenditure and is not deductible as a business expense. Sec. 24 (a) (2), I.R.C. 1939.

BRAXTON C. WALLACE, ESQ., for the petitioners.

RAYMOND WHITEAKER, ESQ., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

ARUNDELL, *Judge:* Respondent has determined deficiencies in the income tax of petitioners as follows:

Taxable Year	*Amount*
December 31, 1951	$13,768.20
December 31, 1952	5,672.06
December 31, 1953	None

The issues are: (1) Whether petitioners are entitled to a business bad debt deduction in each of the years 1951 and 1952 as a result of certain advances which petitioner Edmund Thomas Gulledge, Sr., made during the years 1949 to 1952, inclusive, to a corporation of which he was a stockholder and officer, and (2) whether petitioners are entitled to a deduction in 1953 (for carry-back purposes) of $1,000 expended in the construction of a pond.

As to the first issue, the respondent determined that petitioners were not entitled to deductions for business bad debts but were entitled to deductions for nonbusiness bad debts. He now contends that the said advances were contributions to capital and not loans but, should the Court find that the said advances were loans, he then contends that the advances were not "entirely" worthless in either 1951 or 1952, and by an amendment to answer asks the Court to find increased deficiencies in the event that either one of his present contentions is upheld. Petitioners oppose both of these contentions. They insist they are entitled to deductions, under section 23(k)(1) of the Internal Revenue Code of 1939, for business bad debts or, in the alternative, either to deductions for ordinary and necessary expenses under section 23(a)(1) or deductions for losses under section 23(e)(2) of the 1939 Code.

FINDINGS OF FACT.

The stipulated facts are so found and are incorporated herein by this reference.

Petitioners are husband and wife who reside at Wedgefield, South Carolina. The transactions in question are those of the husband, Edmund Thomas Gulledge, Sr., and he will hereinafter be referred to as the petitioner.

On January 31, 1952, petitioners filed a joint U. S. individual income tax return for the calendar year 1951 with the then collector of internal revenue for the district of South Carolina. On this return petitioner deducted $27,500 as a "casualty" and reported a net income of $25,200.94. The respondent disallowed the claimed deduction of $27,500 and allowed in place thereof a capital loss deduction of $1,000, thereby adjusting petitioners' net income to $51,700.94. In the deficiency notice the respondent explained these two adjustments as follows:

> (a) On your return you deducted the amount of $27,500.00 as casualty. This amount represents cash advances to the Sumter Peanut and Produce Corporation, Sumter, South Carolina. It is held that this amount represents a non-business bad debt rather than a business bad debt. Accordingly, this amount has been disallowed as a deduction and the amount of $1,000.00 has been allowed as a capital loss in item (b) below. Section 23(k)(4) of the Internal Revenue Code.
>
> (b) The amount of $1,000.00 representing a non-business bad debt, has been allowed as a capital loss as explained above. Section 117 (d)(2) of the Internal Revenue Code.

On January 30, 1953, petitioners filed a joint U. S. individual income tax return for the calendar year 1952 with the director of internal revenue for the district of

South Carolina. On this return, petitioner deducted $18,867.04 as a "Casualty (Sumter Peanut Corp. Loss)" and reported a net income of $11,332.53, which included a net capital gain of $467.50. The respondent disallowed the claimed deduction of $18,867.04, allowed in place thereof a capital loss deduction of $1,467.50, and also a net operating loss deduction carry-back from 1953 of $1,402.88, all of which he explained in his deficiency notice as follows:

(a) On your return you deducted the amount of $18,867.04 as casualty (Sumter Peanut Corporation loss). It has been determined that the loans to Sumter Peanut and Produce Corporation in 1952 amount to only $6,550.00. It is held that these loans represent a non-business bad debt rather than a business bad debt. Accordingly, the amount of $18,867.04 deducted on your return has been disallowed and the amount of $1,467.50 has been allowed as a capital loss in item (b) below. Section 23(k)(4) of the Internal Revenue Code.

(b) On your return you reported capital gain of $467.50, representing 50 percent of total net capital gains of $935.00. It is held that the loans explained in item (a) above represent a non-business bad debt allowable as a capital loss to the extent of capital gains plus $1,000.00. Accordingly, the amount of $467.50 reported as capital gain has been eliminated and a net capital loss of $1,000.00 has been allowed, resulting in a total additional deduction of $1,467.50. Section 117(d)(2) of the Internal Revenue Code.

(c) A net operating loss carry-back from 1953 has been allowed as a deduction for 1952, in accordance with Section 122(c) of the Internal Revenue Code.

Net operating loss 1953, as corrected	$2,402.88
Less capital loss deduction for 1952	1,000.00
Net operating loss deduction for 1952	1,402.88

On February 1, 1954, petitioners filed a joint U. S. individual income tax return for the calendar year 1953 with the director of internal revenue for the district of South Carolina, and reported a net income of $1,033.11. After making four adjustments to the reported net income, the respondent arrived at a net operating loss for 1953 of $2,402.88 instead of a net income. One of the adjustments was the disallowance of $1,000 claimed by petitioner as a deduction for machine hire. In his deficiency notice the respondent explained this adjustment as follows:

> (a) On your return you deducted $2,371.75 as machine hire. It has been determined that $1,000.00 of this amount represents the cost of constructing a pond and is a capital expenditure; accordingly, this amount has been disallowed as a deduction. Section 24(a)(2) of the Internal Revenue Code.

Petitioner is a farmer. He has been farming for the past 30 years, raising cotton, peanuts, potatoes, small grain, and livestock. He operates about 1,500 to 2,000 acres and at one time had about 400 acres planted in peanuts. Until about 1942, petitioner also operated a general store in connection with his farm. At some unstated time he also ran a cotton gin. He loaned a little money all his life in connection with one or more of these operations. He had about 32 tenant farmers to whom he made advances, and altogether he had about 300 accounts on his books.

Prior to 1946, petitioner and the other farmers in Sumter County had no local market for their peanuts. Because of this situation petitioner and two other farmers whose names were W. J. Lawrence and H. C. Edens, together with T. O. Bowen, the county agent, took a trip to South Georgia to ascertain, if possible, what profits they could make from a mill in Sumter. They also went to Suffolk, Virginia, and talked with representatives of several peanut companies as to the feasi-

bility of establishing a mill in Sumter on a profitable basis. Upon receiving encouragement, these four individuals returned to Sumter and organized the Sumter Peanut and Produce Corporation (sometimes referred to herein as the corporation) on July 26, 1946. Originally, these individuals intended to invest only $6,000 each in capital stock of the corporation. Bowen borrowed $6,000 to pay for his stock. Later, the outstanding capital stock was increased to $48,000 and, on December 31, 1947, it was owned as follows:

Petitioner	155 shares	$15,500
W. J. Lawrence	155 shares	15,500
H. C. Edens	110 shares	11,000
T. O. Bowen	60 shares	6,000
Total	480 shares	$48,000

By establishing the plant and a market for peanuts, petitioner was able to obtain from $25 to $30 per ton more for his peanuts than he had obtained in the past.

On or about March 25, 1948, Edens and Bowen sold their shares of stock to petitioner and Lawrence and, after such sale, petitioner and Lawrence each owned 50 per cent of the stock of the corporation, or 240 shares each.

On June 30, 1950, petitioner and Lawrence each sold 80 shares of stock in the corporation to R. L. Colvin, after which each of the three shareholders owned 160 shares or a one-third interest in the Sumter Peanut and Produce Corporation.

On or about September 30, 1949, petitioner advanced to the corporation $7,317.04 and Lawrence advanced $7,317.05. On or about June 30, 1950, petitioner and Lawrence each advanced $5,000. During February 1951, petitioner, Lawrence, and Colvin each advanced $2,500 to the corporation. No notes were taken for these advances and no interest was agreed upon. The bookkeeper by

mistake entered these advances on the books of the corporation as "donated surplus." These advances were all intended to be loans and were in fact loans.

It had been the practice of the corporation to issue warehouse receipts for the peanuts as they came into the plant. These warehouse receipts were to be paid off before the peanuts were shelled. Late in 1951 it developed that the manager at the corporation's plant had been shelling peanuts before the payment had been made. The market for peanuts had declined by about 6 or 7 cents a pound, or anywhere from $100 to $130 a ton on shelled peanuts, and it looked as if the corporation would not have funds with which to pay the warehouse receipts. Petitioner and the other two stockholders of the corporation called in W. E. Pate of the state warehouse system of the Agriculture Department and explained the situation to Pate. The conference with Pate resulted in the execution of an agreement signed by the three stockholders, petitioner, Lawrence, and Colvin. The body of the agreement was as follows:

> WHEREAS, the undersigned Stockholders and Directors of Sumter Peanut & Produce Corporation, do hereby assume responsibility and personal liability for the retirement of all outstanding Warehouse recepits in State Warehouses Nos. 1179-G, 1096-G, and 1233-G and
>
> WHEREAS, the undersigned parties do admit that they are responsible for said warehouse receipts no matter how many and what amounts, together with all storage charges thereon and agree to fully retire and counsel [sic] the same on or before the 15th day of December 1951.
>
> NOW, THEREFORE, in consideration of the premises, we, the undersigned, do hereby bind ourselves, to retire and cancel all of said warehouse receipts, together with storage on or before December 15, 1951.

This Agreement shall be binding upon the parties hereto, their heirs and assigns.

Witness the hand and seal of the parties hereto this the 20th day of November 1951.

In the execution of the above agreement the three stockholders of the corporation advanced further sums to the corporation or to the trustees in liquidation, as hereinafter shown, on approximately the following dates and in the following amounts:

Approximate Date of Advance	*By Petitioner*	*By Lawrence*	*By Colvin*
Dec. 15, 1951	$25,000	$20,000	$15,000
Jan. 15, 1952	2,000	2,000	2,000
Feb. 1, 1952	3,000	3,000	3,000
Mar. 15, 1952	1,550	1,550	1,550
Total	$31,550	$26,550	$21,550

These amounts were set up on the books of the corporation as liabilities under the caption of "Refinance Loan Account.' No notes were given for any of the advances nor was there any agreement as to interest.

On January 3, 1952, the stockholders of the corporation caused all of the corporation's property to be transferred to petitioner and Lawrence as trustees, "IN TRUST, to take and hold said property, rent out the same, sell said property, and apply proceeds of said sale upon the indebtedness due by the grantor, and should any surplus remain, then to divide the same among the said W. J. Lawrence, Jr., E. T. Gulledge, and R. E. Colvin in proportion to the amount each of the said three has invested in said Sumter Peanut and Produce Corporation."

On January 4, 1952, pursuant to notice duly published on three occasions in the Sumter Daily Item of Sumter, South

Carolina, a meeting of the stockholders of the corporations was held, and the following resolution was unanimously adopted:

> RESOLVED: that the charter be surrendered and the corporation be liquidated and the real estate be conveyed to the stockholders and that an application be made to the Secretary of State for a dissolution of the Charter.

A balance sheet prepared by the accountant for the corporation showing the assets and liabilities in the hands of the trustees, as taken from the books as of July 31, 1952, is as follows:

Assets:

Cash		$ 1,136.34
Accounts receivable		12,198.07
Inventories		5,043.00
Deposits and prepaid insurance		296.83
Total current assets		$ 18,674.24
Land	$ 1,960.48	
Buildings	23,306.35	
Machinery and equipment	42,851.52	
Furniture and fixtures	353.50	
	$68,471.85	
Less depreciation	17,164.39	
Total fixed assets		51,307.46
Total assets		$ 69,981.70
Deficit		129,469.73
		$199,451.43

Liabilities and Capital:

Accounts payable		$ 1,025.98
Notes payable (bank)		8,000.00
Mortgage payable (bank)		30,000.00
Reserve for payroll tax		641.38
Loans from stockholders		$111,784.09
Total liabilities		151,451.43
Capital stock		48,000.00
		$199,451.43

Petitioner	$ 46,367.04
Lawrence	41,367.05
Colvin	24,050.00
	$111,784.09

---

*A summary of these loans is as follows:

On January 21, 1954, petitioner, as the highest bidder, bid in at public sale, after due public advertisement of the sale, all of the property of the corporation then held by the trustees for $22,000 and also assumed an existing mortgage on the property of $10,000, thus making the total purchase price $32,000.

None of the advances which petitioner made to the corporation as previously set forth, in the total amount of $46,367.04, was a contribution of capital.

The advances which petitioner made to the corporation prior to 1952 were entirely worthless at the end of 1951.

The advances which petitioner made to the corporation during 1952 were entirely worthless at the time they were made pursuant to the agreement entered into on November 29, 1951.

The loss resulting from the debts which became worthless had no relation to any trade or business in which the petitioner was engaged at the time the debts became worthless.

2. In 1953, petitioner built a pond on his property primarily for his cattle and for irrigation purposes. The cost of the pond was about $4,500. About $1,000 of this cost represented machine hire which petitioner deducted as an ordinary and necessary business expense.

OPINION.

The respondent's determination that the deductions claimed by petitioner in 1951 of $27,500 and in 1952 of $18,867.04 were nonbusiness rather than business bad debts is prima facie correct, and the burden of proof is upon anyone who attacks that determination. See our Rule 32, and *Avery* v. *Commissioner*, (C.A. 5, 1927) 22 F. 2d 6. Both parties now contest the determination but seek different results.

We do not agree with respondent's first contention that the advances made by petitioner to the corporation were contributions of capital rather than loans. Petitioner paid in to the corporation $15,500 for his 155 shares of stock held on December 31, 1947. He later purchased some of the shares held by Edens and Bowen and sold 80 shares to Colvin. After June 30, 1950, he owned 160 shares. Petitioner has made no claim for any loss due to his stockholdings. The evidence clearly shows that the total advances here in question made by petitioner of $46,367.04 were intended as loans. The fact that the bookkeeper mistakenly recorded $14,817.04 of the advances as donated surplus is not controlling. Nor does the fact that no notes were given or interest agreed upon make the advances capital rather than loans. The evidence clearly establishes that petitioner never intended the advances made by him to be other than loans. He had no doubt as to the repayment of all of the advances except the sum loaned in 1952 and the advances made in that year were made by reason of a definite commitment entered into in 1951. The fact that the repayment of the 1952 loans of $6,550 was doubtful when made does

not change the character of the advances as loans when made in the light of the commitment to make such advances. Cf. *Eckert* v. *Burnet* (1931) 283 U.S. 140, affirming the Court of Appeals for the Second Circuit at 42 F. 2d 168, which in turn affirmed our decision reported at 17 B.T.A. 263. We hold, therefore, that respondent has failed to prove that any part of the advances of $46,367.04 was a contribution of capital rather than a loan.

Neither do we agree with the respondent's second contention that the debts were not "entirely"[1] worthless when charged off by the petitioner in 1951 and 1952. He bases this contention mainly on the ground that as of July 31, 1952, the trustees held assets of the corporation totaling $69,981.70 with which the trustees could have paid off all the non-stockholder liabilities of $39,667.34 and have had $30,314.36 left to apply on the loans from stockholders of $111,784.09. This might be true if the assets were worth par. The trustees, however, after trying to sell the assets for over a year finally put them up for sale at public auction at which time petitioner as the highest bidder bid them in for only $22,000 and assumed an existing mortgage thereon of $10,000. We hold that the respondent, on whom the burden rests on this point, has failed to prove that the debts were not entirely worthless at the time of their charge-off by petitioner.

Regarding petitioner's contention that the debts were business rather than nonbusiness, it is necessary for petitioner to prove that in the years the debts became entirely worthless petitioner was engaged in a trade or business, and that the loss resulting from the debts becoming worthless

---

1. Both section 29.23(k)-6 of Regulations 111, applicable to year 1951, and section 39.23(k)-6 of Regulations 118, applicable to the year 1952, provide that:

> In the case of a taxpayer, other than a corporation, if a nonbusiness bad debt becomes entirely worthless * * * the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months.

bore a proximate relation to such trade or business. *Jan G. J. Boissevain*, 17 T.C. 325; *Commissioner* v. *Smith*, (C.A. 2, 1953) 203 F. 2d 310, reversing *Weldon D. Smith*, 17 T.C. 135; *Hickerson* v. *Commissioner*, (C.A. 2, 1956) 229 F. 2d 631, affirming a Memorandum Opinion of this Court; *Dominick J. Salomone*, 27 T.C. 75 (Jan. 17, 1957). Petitioner has shown that he has been in the business of farming for the past 30 years. But the loans here in question have no proximate relation to that business. They were all made to further the business of the corporation. The business of the corporation is not petitioner's business. *Dalton* v. *Bowers*, 287 U.S. 404; *Burnet* v. *Clark*, 287 U.S. 410. Petitioner is not in the business of lending money to corporations generally. He did testify that he made some small loans to sharecroppers but to what extent we do not know.

It thus appears that petitioner was not engaged, during the taxable years in question, in any trade or business other than that of farming, and that this was separate from the business of the corporation. We hold, therefore, that petitioner has failed to establish that the debts in question were business rather than nonbusiness as determined by the respondent.

Since we have held that the advances which petitioner made to the corporation are loans and are therefore debts of the corporation, we think it follows that there can be no merit in petitioner's alternative contentions that the losses resulting from the worthlessness of the debts are deductible either as deductions for ordinary and necessary expenses under section 23 (a)(1) or deductions for losses under section 23 (e)(2) of the 1939 Code. These sections, together with section 23 (k), are all mutually exclusive. *Spring City Foundry Co.* v. *Commissioner*, (1934) 292 U.S. 182.

2. In 1953, petitioner built a pond on his property and deducted a part of the cost thereof as a business expense. The respondent disallowed the deduction in accordance with section 24 (a)(2) of the Internal Revenue Code of 1939,

which provides that in computing net income no deduction shall in any case be allowed in respect of "Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate * * *." We hold that the respondent did not err in disallowing the deduction.

Decision will be entered for the respondent.

THE TAX COURT OF THE UNITED STATES

WASHINGTON

EDMUND THOMAS GULLEDGE, Sr., and LUCY COULTER GULLEDGE, Husband and Wife,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 59548.

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed February 13, 1957, it is ORDERED AND DECIDED: That there are deficiencies in income tax for the taxable years ended December 31, 1951, and December 31, 1952, in the respective amounts of $13,768.20 and $5,672.06, and that

there is no deficiency in income tax for the taxable year ended December 31, 1953.

(Signed) C. R. ARUNDELL, *Judge.*

Entered February 13, 1957

FOR THE FOURTH CIRCUIT

No. 7501.

Edmund Thomas Gulledge, Sr., and
Lucy Coulter Gulledge, Husband and Wife,
Petitioners,

versus

Commissioner of Internal Revenue,
Respondent,

ON PETITION TO REVIEW THE DECISION OF
THE TAX COURT OF THE UNITED STATES.

(Argued October 11, 1957. Decided November 7, 1957.)
Before SOPER, SOBELOFF *and* HAYNSWORTH, Circuit Judges.

Wilton H. Wallace and Braxton C. Wallace (Henry F. Lerch on brief) for Petitioners, and James P. Turner, Attorney, Department of Justice, (John N. Stull, Acting Assistant Attorney General; Lee A. Jackson and Harry Baum, Attorneys, Department of Justice, on brief) for Respondent.

SOPER, Circuit Judge:

The question on this appeal is whether certain loans, which had been made by the taxpayer to a corporation and had become worthless in the years 1951 and 1952, consti-

tuted business bad debts deductible in full from gross income under §23(k)(1) of the Internal Revenue Code, or non-business debts to be treated as losses from the sale or exchange of capital assets held for not more than six months, and therefore deductible in a limited amount under §23(k)(4).[1]

Edmund T. Gulledge, the taxpayer, and his wife, who is a party only because joint returns were filed, made a deduction for the year 1951 in the sum of $27,500.00 and a deduction for 1952 in the sum of $18,967.04 for losses on loans made to the Sumter Peanut and Produce Corporation of Sumter, South Carolina, on the theory that the loans amounted to bad business debts; but the Commissioner held that the loans represented non-business debts and allowed as a deduction only $1,000.00 in 1951 and $1,467.50 in 1952, offsetting a $467.50 capital gain reported for that year. The Tax Court sustained the Commissioner's determinations.

Gulledge was a farmer in Sumter County, South Carolina, who operated 1500 to 2000 acres of land, of which 400 acres were planted in peanuts. He had about 32 tenant farmers and about 100 additional families to which he made

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[1] Internal Revenue Code, 1939:

Sec. 23. Deductions from Gross Income.

"(k) Bad Debts.—

(1) GENERAL RULE.—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year as a deduction. * * *

* * *

(4) Non-Business Debts.—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term 'non-business debt' means a debt other than a debt evidenced by a security as defined in paragraph (5) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

advances in connection with his farming operations. It is conceded, however, that he was not in the business of promoting or lending moneys to corporations. In 1946, when the transactions began, which ultimately led to the losses under examination, the peanut acreage in Sumter County amounted to 4000 acres, but the nearest markets for peanuts were located 150 to 200 miles away and the growers in Sumter County were at a disadvantage in getting fair prices for their crops because they were obliged to sell to buyers who traversed the countryside in trucks and bought peanuts for whatever price they could negotiate. Accordingly, the taxpayer and three other persons, two of whom were large growers of peanuts, made inquiry from established peanut companies to ascertain whether it would be a profitable undertaking to set up a marketing and processing plant for peanuts in Sumter County. Upon receiving encouraging reports as to the feasibility of the venture they set up such a plant in Sumter County. In all, they invested $48,000.00 in the capital stock of the corporation, of which the taxpayers contributed $15,500.00, and as a result the growers in the county obtained an advance from $25.00 to $30.00 per ton on the price of their peanuts; and the investors testified that they considered the business of the corporation as part of their farming operations. The business of the corporation, however, was not successful and the taxpayer advanced various sums as loans to the corporation in the years 1949 to 1952 aggregating the sum of $46,367.00. Other stockholders also advanced substantial sums. All of this money, however, was lost and finally, in 1952, the corporation was dissolved and its real estate was conveyed to the stockholders.

In these circumstances we think that the decision of the Tax Court must be affirmed since a proximate relationship between the losses and the business of the taxpayer was not established within the meaning of the statute and the applicable regulations. Section 29.23(k)(6) of Regulations 111 applicable to 1951, and the corresponding section of

a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection. . . .

• • •

(4) Non-business Debts.—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3), and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

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In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 696

EDMUND THOMAS GUILLEBEAU, JR., AND LUCY COULTER GUILLEBEAU, HUSBAND AND WIFE, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Pet. 1a-14a) are not officially reported. The opinion of the Court of Appeals (Pet. 15a-19a) is reported at 249 F. 2d 225.

JURISDICTION

The judgment of the Court of Appeals was entered November 7, 1957. (Pet. 19a-20a.) On January 31, 1958, an order was entered extending the time within which to file the petition for a writ of certiorari to April 5, 1958. The petition was filed on April 4, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

separate taxable entity. It was set up to purchase and process not only taxpayer's crop, but also the crops of other peanut growers in the locality, with the expectation of making a profit out of that business. (Pet. 5a-8a, 16a-17a.) That one of the reasons for which the corporation was formed was to create a better market for taxpayer's farming products does not, as taxpayer assumes (Pet. 12-13), serve to render his "business" the same as that of the corporation within the purview of Section 23 (k). Moreover, while this may have been one of several motives for the formation of the corporation, the evidence clearly shows that the loans thereafter made to it were directly related to the corporation's business of buying and processing peanuts, and that the loss resulting from the debt's becoming worthless was not sustained in carrying on taxpayer's separate farming operations. (Pet. 7a-8a.) Under the circumstances the Tax Court was fully justified in concluding that the losses were non-business rather than business bad debts losses, and under familiar rules governing the scope of judicial review of the Tax Court's factual determinations, the court below was equally justified in affirming.

3. There is no conflict with any appellate decision, nor is any asserted. The Tax Court decisions upon which taxpayer relies (Pet. 13-14), turn on clearly distinguishable facts. As the court below observed (Pet. 19a), these cases do not require a different result here.

CONCLUSION

The decision below is correct, there is no conflict and no question of general importance is presented. The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
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CHARLES K. RICE,
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MAY 1958.

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